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THE CASE FOR TAX CUTS NOW

INTRODUCTION

As President Reagan prepares his budget for the 1983 fiscal year, the nation's economic barometers are signalling stormy weather. From both sides of the congressional aisle -- even from those who should know better -- cries are heard imploring Reagan to abandon his supply-side strategy, in operation less than four months. Yet there are strong arguments for the President to stay resolutely on course. There even are calls for supply-side economics really to be given a chance by accelerating the scheduled tax cuts and not, as some critics propose, postponing them.

Although the debate on the Reagan tax cuts occurred less than seven months ago, many seem to have forgotten -- even some in the Administration -- the fundamental reasons underlying the policy: that high marginal tax rates destroy the kind of productive activities most needed in an economic downturn. The most important barrier to economic recovery today is the heavy load of taxes helping to keep factories idle, investment opportunities unexploited and, ultimately, willing workers unemployed.

Between 1965 and 1975 the average tax rates for the median income earner increased more than 35 percent. Those rates increased an additional 22 percent between 1975 and 1980, mainly due to inflation-induced tax bracket creep. The marginal tax rate faced by the median-income family of four in 1980 was 24 percent. Taking into account Social Security and state tax increases, the marginal tax rate facing the average American family is 40-44 percent.[1] On the average, this amounts to some

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1 Paul Craig Roberts, Assistant Secretary of the Treasury for Economic Policy, "Statement Before the House Task Force on Economic Policy," Washington, D.C., July 27, 1981.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

$10,690 per household. Does anyone seriously think that adding to this burden would create a more healthy economy?

Unless action is taken, however, an already over-taxed economy will be burdened with yet another stiff tax hike in 1982. A Social Security tax increase of $13 billion greeted Americans on January 1 and they can look forward to income tax increases of $28 billion because of tax bracket creep.[2] (See Appendix 1.) The 10 percent personal tax reduction scheduled for July will only offset these automatic tax increases.

The other scheduled cuts are in large part only reductions of planned tax increases. The nature of the U.S. tax system permits massive tax increases to occur automatically because of inflation. No direct legislation is required. Despite the much-publicized "Reagan revolution" in tax policy, the fully implemented tax cut will at best return the nation to the level of taxation in 1978. Even with the cuts, total revenues will increase over $300 billion during the next five years. According to the Congressional Budget Office (CBO), tax levies will rise from $605 billion in 1981 to $923.3 billion in 1986.

And yet many in Congress and the Administration actually propose to reverse the economic slowdown by raising taxes even more. Apparently, the message that taxes are the major cause of our economic malaise has still not been universally learned. Higher taxes do not reduce prices nor fight inflation. Higher taxes do not increase employment nor stimulate economic growth. Rather, tax increases exacerbate the problems of unemployment, low productivity, and economic stagnation.

Accelerating the tax cut would help relieve the heavy tax burden which supply-siders contend is a chief cause of economic deterioration in recent years. More than two dozen Congressmen, spurred by Representatives Jack Kemp (R-N.Y.) and Robert Walker (R-Pa.), are urging the President to speed up the tax cuts by six months. They argue that with over 9 million Americans unemployed and the economy running at only about 75 percent of capacity, fallow resources could be employed by enhancing the incentives for productive work and investment. Tax cuts, not tax increases, they say, generate the long-term prosperity that, among other things, eventually will restrain and then eliminate the deficit. These Congressmen have introduced a bill (H.R. 4999) that would move up the tax cut scheduled for July 1982 to January and the July 1983 tax cut to January 1983. While some hope for the full 25 percent tax rate reduction to be made effective immediately, or, even better, that full indexing of tax brackets for inflation be started now rather than 1985, most supply-siders seem to be coalescing around the Kemp-Walker proposal as a remedy for the current recession.

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2 "What the Tax Cut Really Does," Human Events, November 21, 1981, p. 5.

Supply-siders figure that the quickest way to reduce the burgeoning deficit is to stimulate the economy to recovery, thereby reducing expenditures for social welfare programs and increasing tax revenues. They point out that four-fifths of the recent increase in estimates of the proposed deficit are caused by a deteriorating economy, not by the upcoming tax cut. Expenditures for unemployment compensation, food stamps, and other entitlements have increased rapidly since July, while the economic decline has reduced tax revenues. A reinvigorated economy, however, could quickly eliminate the budget deficit. The CBO estimates that for every one percentage point decline in the unemployment rate, the deficit is reduced $25 billion. A reduction in the unemployment rate from the current 9 percent to 6 percent could nearly wipe out the budget deficit for the coming year. While few think that accelerating the tax cut stimulates economic growth quite this powerfully, most supply-siders think it could shorten the recession and, in the long term, slash the deficit.

Other analysts confirm the basic Kemp-Walker arguments. A U.S. Chamber of Commmerce study finds that a six-month speed-up in the personal tax rate reductions would significantly stimulate real economic growth in 1982 and 1983, substantially reduce the unemployment rate, and increase business investment and productivity -- without increasing the rate of inflation at all. According to the study, the measure provides taxpayers with more than $16 billion in relief in 1982 and more than $17 billion in 1983.[3] While this falls far short of offsetting all the tax increases scheduled for those years, it does fully offset Social Security tax increases and tax bracket creep.

Tax cuts spur the entrepreneurship of small, often unincorporated businesses by allowing entrepreneurs to retain a greater share of their own earnings. Small business entrepreneurship helps pull the country out of downturns and provides important sources of innovation and employment in times of recovery. Nearly 70 percent of all new jobs come from firms with twenty or fewer employees. In the Northeast, nearly 100 percent come from these miniscule businesses.[4] A tax code which rewards inherently risky entrepreneurial activity encourages an early exit from the current recession and a sustained recovery. David Smick, chief of staff for Congressman Kemp, writes: "entrepreneurial success in America is taxed and harassed more than in just about any other free industrialized country."[5] Ninety percent of American firms, for instance, pay taxes through personal schedules, either

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3 Chamber of Commerce of the United States, Forecast Center, Letter to Jack Howard, Office of Congressman Walker, from Graciela T. Ortiz, November 19, 1981.

4 David M. Smick, "What Reaganomics is All About," The Wall Street Journal, July 8, 1981.

5 Ibid.

as a partnership or as an unincorporated business activity. A tax cut speed-up should expand the pool of capital available to all businesses, but especially to capital-starved small enterprises. Lately, after the government takes its enormous bite of the available capital, and big business gathers up the rest, there is little left for smaller enterprises. It is likely that much of the increased pool of saving will go to small enterprises now being crowded out of capital markets. And because most small businesses first get their start by borrowing funds from friends, relatives, or small local banks, an acceleration of the personal tax cut could mean more funds from these sources.

Supply-siders feel the additional relief is vitally important to avert a net tax increase that would deepen the recession and cause needless social suffering. "If there is one mistake that the Administration has made in economic policy," Kemp has remarked, "it is in delaying the tax cut." Adds Walker: "The first round of tax cuts does not provide a sufficient measure of relief to the American worker and therefore doesn't provide enough time between the July 1 ten percent reduction and the end of the fiscal year for the economy to snap back in time to show solid evidence of economic recovery." He concludes that "if we have the opportunity to put people back to work we should take advantage of it."

THE CRIES FOR TAX BOOSTS

The Kemp-Walker arguments are falling on some deaf ears in Washington. According to recent reports, top White House and budget department officials almost unanimously advocate tax increases to balance the budget. Budget director David Stockman, Chief of Staff James Baker, III, Counselor to the President Edwin Meese, III, and Deputy Chief of Staff Michael K. Deaver reportedly favor a total of $45 billion in new taxes over the next two years.

It appears that only President Reagan himself, and possibly some Treasury Department aides, oppose raising taxes substantially over the next few years. Recently, the President signalled once again his opposition to tax raises. Communications chief David Gergen told reporters, "The President...is opposed to any new increases in taxes. He believes that the growing burden of taxation has been a major contributor to the economic deterioration of recent years. He also believes that the tax cuts passed earlier this year lay a strong foundation for economic recovery in 1982 and should not be changed."

The President's determined opposition to personal tax increases finds strong substantiation in almost any economic theory. Since President Herbert Hoover raised taxes at the outset of the Great Depression to balance the budget, almost all economists have agreed that taxes should not be raised in a recession. Economic theories which battle over many points agree, in as

close to unanimity as they are likely ever to come, that tax increases in a recession further depress economic activity, increase unemployment, and delay recovery. Keynesians think tax increases dampen aggregate demand and reduce the national output; monetarists contend tax increases reduce pressure on Congress to cut government spending -- the most important factor depressing the economy; and supply-siders think tax increases create disincentives for work, saving and investing.

Despite the consensus of economic theory and this strong statement by the President, the calls for tax hikes continue. And some fiscal conservatives who never accepted supply-side tenets in the first place are now resurfacing with gleeful warnings of the dire consequences of deficits allegedly arising from tax cuts. Even political liberals, blind to deficits caused by increased government spending in the last twenty years, suddenly are singing the praises of a balanced budget. G. William Miller, Jimmy Carter's Secretary of the Treasury, calls for a tax increase on gasoline; syndicated columnist George F. Will argues for a windfall profits tax on deregulated natural gas; and Senate Majority Leader Howard Baker floats the ideas of a national sales tax or excise tax on liquor and cigarettes. This tax hike momentum scored a victory of sorts in a December sense-of-the-Senate resolution urging tax increases to balance the budget.

There have been near victories of a similar sort in the White House. In fact, so many presidential advisors have rushed to the tax hike side that Ronald Reagan seems, at times, the sole remaining keeper of the supply-side faith. It is said, regrettably not only in jest, that the President is now the supply-side "mole" inside his own White House.

Supply-side leaders on Capitol Hill are disturbed by the readiness of top budget and White House officials to reverse the Administration's economic program. Many feel betrayed by the President's advisors who so easily have conceded the intellectual grounds for the supply-side tax cuts. This seems to confirm their original fears that Reagan was surrounding himself with advisors not deeply committed to his economic program.

IS IT A REAGAN RECESSION?

There is little evidence that supply-side economics has failed. Yet this does not prevent House Speaker Thomas (Tip) O'Neill (D-Mass.) from referring to the "Reagan recession," or the "Reagan deficit," implying that the current slowdown is a result of Administration policies. O'Neill clearly is ignoring the evidence to the contrary. For example, the current economic slowdown started at least by the second quarter of 1981 when economic production first fell and when in July, the unemployment rate increased to from 7 percent to 7.2 percent of the workforce.

By this early date, however, none of the major planks of the Reagan economic program were in place. The across-the-board tax cut did not even take effect until October 1 -- at least two months after the recession had begun. The budget cuts also cannot be blamed for the economic slowdown. Most of the cuts are only now becoming effective. The FY 1981 budget contained insignificant cuts in a few programs and hiked overall spending by over $80 billion. Even the monetary policy of the Federal Reserve during the Reagan Administration cannot be blamed for the recession. During the first quarter of the year, the Federal Reserve aggressively expanded the money supply. While many believe this was reckless for other reasons, the policy cannot be blamed for an immediate recession. Only regulatory reform has been implemented to any degree, since the Administration can eliminate regulation without congressional action. No one has suggested that deregulating business causes economic slowdowns.

There were signs, in fact, of an impending recession before the Reagan Administration took office. In a memorandum entitled "Avoiding a GOP Economic Dunkirk," Jack Kemp and others warned of a gathering economic storm which threatened a recession early in the President's term. They warned that Reagan would inherit "thoroughly disordered credit and capital markets, punishingly high interests rates," high inflation expectations, and the possibility that the federal budget could become an automatic "coast-to-coast soup line," dispensing remedial aid with almost reckless abandon. The memorandum argued that attempts to cut the budget would fail in a recessionary environment. Their solution was to avert recession by enacting tax cuts to spur economic growth and lower inflation expectations. "For this reason," the memorandum concluded, "dilution of the tax cut program in order to limit short-run static revenue losses during the remainder of FY 1981 and FY 1982 would be counter-productive."

This advice was ignored as multiple concessions were made in the timing and magnitude of the tax cuts ultimately enacted by Congress. When the cut was introduced by Kemp in July of 1977, the reductions amounted to 30 percent in one year. When Reagan decided to make the Kemp proposal the centerpiece of his economic recovery plan in the summer of 1979, he wooed moderates by agreeing to phase in the reductions over three years starting January 1, 1981. In the 1981 fight with Congress, Reagan was forced to make the most damaging concessions: 1) the size of the tax cut was reduced from 30 percent to 25 percent; 2) the first stage of the tax reduction was delayed from January 1, 1981 to October 1; and, 3) in a final concession, the other two stages of the cut were similarly delayed six months. This meant that taxpayers realized only a 1.25 percent effective cut in 1981 tax rates and will not get their 10 percent cut until 1982. Nothing has been done, moreover, about the automatic increases in other taxes.

TAX CUTS: A BOON TO BUDGET CUTS

Supply-side economists are not alone in favoring speeding-up the tax cut. Many other economists urge tax cuts because, they say, reducing government revenues is one way to force a reduction in the federal budget. In short, these economists want to keep extra tax revenues out of the hands of Congress. Milton Friedman contends that: "I am in favor of cutting taxes at any time under any pretense for any reason in almost any way. There are better and worse tax cuts, of course, but the most important thing is to keep your eye on is cutting taxes."[6]

Friedman and others favor additional tax cuts primarily as a way of changing the trend of recent years toward greater centralization and regulation of the economy. Every increase in government spending, Friedman notes, causes the private sector to contract in order to release resources to the government. Although it rarely has been tried, the reverse can also occur. As government spending is reduced, resources are released that allow the private sector to expand.

DEFICITS AS A SCAPEGOAT

Many sounding the loudest alarms about budget deficits are, ironically, precisely those political figures most responsible for the staggering increases in government spending over the past twenty years. They are, quips Milton Friedman, born-again budget balancers. Most seem to be concerned only with deficits caused by tax cuts and not when they are caused by spending increases. It is thus a fair question whether they are sincerely opposed to an unbalanced budget, especially during times of recession, or whether they are simply setting the stage for tax increases -- followed by further spending increases. According to Friedman, "The reason they are born-again budget balancers and are now talking about raising taxes is not because they've fundamentally changed their view, but because they recognize that the most effective way to hold down government spending is to hold down government revenue." Would raising taxes result in a balanced budget? Friedman does not think so. "They are talking as if their concern is to enact higher taxes in order to keep budget deficits down," he says. "Their real motive is to keep taxes up so that the government can resume big spending programs as soon as the present public drive for lower taxes and spending passes."[7]

Some arguing for tax increases, however, are fiscal conservatives worried that unbalanced budgets harm the economy. Friedman warns these conservatives in rather strong language that they should not be tricked into supporting tax increases. If fiscal

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[6] Milton Friedman, Human Events interview, December 5, 1981.
[7] Ibid.

conservatives join with the liberals in supporting tax increases, says Friedman, "They will prove that they have learned absolutely nothing from the history of the past 30 years and they ought to have their heads examined."

Former Chairman of the Council of Economic Advisors Paul McCracken also chastizes conservatives for wanting to delay tax cuts until the budget is balanced. "The strategy of holding off on any tax action until the budget is balanced," writes Dr. McCracken, "is simply leading us down the road to yet higher levels of public spending and budgets chronically in the red."[8]

DEFICITS AND TAX CUTS

Yet the high deficit projections scare many people into believing that higher taxes -- or what is now the newest addition to government newspeak, "revenue-enhancers" -- must be tolerated. In absence of further budget cuts, the 1982 deficit is now expected to increase to $109.1 billion, $152.3 billion the following year, and $162 billion in 1984. Opponents of the Kemp-Walker initiative argue that accelerating the tax cut would further cut government revenues by almost $34 billion in 1982 and 1983, widening the deficit yet further.

These critics ignore history. Higher taxes have rarely created a balanced budget. For twenty years, tax revenues have leaped annually higher through inflation-induced budget creep and explicit tax hikes passed by Congress. The result: a budget still deep in the red. What happens, it seems, is that higher taxes merely feed the insatiable appetite of higher spending.

Deficits, of course, do matter. The Treasury borrowing needed to cover the deficit elbows private investors out of capital markers, increases interest rates, and pressures the Federal Reserve to increase the money supply (this is called monetizing the debt). But taxes depress private sector activity as well. Every increase in taxes is accompanied by a shrinkage in the private sector. Much of the analysis of deficits, moreover, is incomplete and confuses economic causes and effects. The cause of current U.S. economic problems is high government spending, rising tax rates, and an unstable money supply. High deficits are the symptoms of these problems and will persist until the government-imposed barriers to economic development are lifted. Until government spending is reduced, an anemic private sector will be starved for funds. Until high taxes are cut sharply, disincentives to work, save and invest will prevent an economic recovery. Until money growth is reduced and made stable, an unpredictable inflationary environment will depress saving and render long-term investing too risky.

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8 Paul W. McCracken, "Reagan's Tax Plan Makes Sense," The Wall Street Journal, June 10, 1981.

These impediments to economic growth are the culprits chiefly causing deficits, not the tax cuts. Most of the current deficit has been the result of a deteriorating economy.[9] Before the recession, the Office of Management and Budget (OMB) was estimating the deficit at $42.5 billion for FY 1982, $52.7 billion for FY 1983 and $44.2 billion for FY 1984. Since that July prediction, however, OMB's deficit estimates have soared by $230 billion for the three years. A deteriorating economy accounts for over 80 percent of the increase in deficit estimates. Over $185 billion of this increase results not from the Reagan program but from a sinking economy. According to an analysis prepared by Representative Kemp, the increased deficits are caused by three factors:[10]

1) Reduced government revenues because of unemployment, business bankruptcies, and relative decreases in wages, rents, and profits. This alone accounts for a surge in the deficit of $142 billion.

2) Increased government spending for unemployment compensation, food stamps and many other social programs which increase during times of economic slowdown hike the budget deficit by $11.8 billion.

3) Higher interest rates than predicted added $31.5 billion to the cost of financing the national debt.

Many believe accelerating the tax cut will reduce and eventually eliminate the budget deficit by creating the foundation for a prosperous economy. The stepped-up economic growth induced by tax cuts sharply increases government receipts by raising wages, profits, and rents, and reduces government spending by dampening the need for social services. Each one percentage point decrease in the unemployment rate narrows the deficit by about $25 billion. As Congress increasingly balks at making further budget cuts, supply-siders argue that the only feasible means of controlling the deficit is to accelerate economic recovery with a tax cut.

A growing number of leaders support accelerating the tax cut including, it appears, Ronald Reagan, top Treasury officials, business organizations, and supply-side proponents on Capitol Hill. Paul Craig Roberts, Assistant Treasury Secretary for Economic Policy, is known to be promoting the idea along with other top leaders at Treasury. Moreover, the President in a recent interview with the Westinghouse Broadcasting Corporation, observed that the recession "might not have happened" if Congress had allowed all his tax-cut measures to begin retroactively to last January 1, as originally proposed, rather than being delayed

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[9] This analysis is taken from a handout prepared by Representative Jack Kemp, "Anatomy of a Deficit," undated and unpublished.

[10] Ibid.

nine months. "I still believe that, had we gained on either of these two points, January or July, that this recession might not have happened," Reagan said.

The measure is also gaining strong endorsement from the business community. Both the U.S. Chamber of Commerce and the Wall Street Journal have provided vigorous support for faster tax cuts. The Journal concluded in a November 12 editorial that "there would be far more confidence...if the next 10 percent tax cut were going into effect in January, not July. That is, if taxes were cut not less but MORE."

THE EVIDENCE ON DEFICITS

The current debate on deficits shows a disturbing lack in knowledge of even the most rudimentary principles of monetary economics. Much of the problem stems from the flawed understanding of the real versus imaginary effects of budget deficits. Recent evidence indicates that the conventional wisdom on budget deficits is seriously in error. Separate studies by Robert Weintraub of the Joint Economic Committee, Robert Barro of the University of Rochester, and William Niskanen of the Council of Economic Advisors, have all found, contrary to popular opinion, that high deficits need not cause high inflation or high interest rates if money growth is held constant.

Some recent historical cases back up these academic studies. In 1973, the U.S. had relatively high inflation and high interest rates, but low deficits. Conversely, in 1975, the U.S. experienced large deficits but relatively low interest rates and inflation. This experience is not unique to the U.S. Deficits have been associated with stagnant economies as well as booming ones like Japan and Germany. Both countries ran budget deficits totalling about 4 percent of their GNP in 1980. The U.S. in comparison had a deficit amounting to less than 2.3 percent of its GNP during this same period. Yet the U.S. had significantly higher inflation, interest rates, and unemployment than either country, and much lower growth than Japan.[11] Clearly, budget deficits do not explain differences in economic performance between countries.

Why don't high deficits necessarily cause rising interest rates and inflation? Most economists today believe that monetary growth is the key factor in causing high interest rates and inflation. Deficits are not even a ball park indicator of money growth. As David Meiselman points out, "The relationship between money per unit of output and inflation may well be the most extensively tested proposition in all of economics with few, if any, exceptions."[12] Put crudely, inflation results when the

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[11] The Economist, November 21, 1981, p. 107.
[12] David Meiselman, "Deficits, Money, and the Cause of Inflation," The Wall Street Journal, July 21, 1981.

money supply outpaces the growth in the output of goods and services.

An accelerating money supply is also the cause of rising interest rates. An important component of interest rates is inflation expectations. The inflation premium in interest rates compensates bondholders for receiving dollars of depreciating value. The major factor causing high interest rates today is the investing community's belief that inflation will continue to depress the value of their saving. If monetary growth is reduced, inflation will subside and one can expect that interest rates will accordingly decline.

The level of budget deficits, however, appears to indicate little about the rate of money growth. Government deficits need not be a source of inflation unless the Federal Reserve is induced to expand the money supply -- what in economic jargon is called monetizing debt. The Fed monetizes the federal debt simply by buying government bonds from the Treasury or from individuals. Because the Fed is the nation's chief banker, it pays for the bonds by crediting bank reserves held at the central bank. Whether the purchase is from individuals or the U.S. Treasury, crediting bank reserves has the same effect as paying with newly printed money. Monetizing the debt increases the nation's money supply and fuels inflation after a lag in time.

Yet the Federal Reserve is not required to monetize the federal debt. The following Table indicates that the Fed has not always increased the money supply to finance government debt. Meiselman writes, "Although the Fed blames deficits for causing inflationary money growth, the evidence is that, from 1960 to 1980, there was no significant relationship between changes in money supply and changes in the national debt. Not only is there

Table 1

	Federal Deficit	Purchases of Debt by Fed	% Deficit Monetized
1973	$ 7.9 billion	$9.2 billion	116%
1974	10.9	6.1	56
1975	75.1	8.5	11
1976	56.6	9.8	17
1977	50.9	7.1	14
1978	43.8	6.9	16
1979	28.1	7.7	27
1980	67.8	4.5	7
1981a	24.3	1.6	6

a -- Nine months

Source: Federal Reserve data.

no legal or practical need to monetize increases in the debt, the Fed has not systematically done so."[13]

The blame for the inflation plaguing our country in recent years should be placed squarely on the Federal Reserve Board's failure to provide a stable and declining growth in money supply. Milton Friedman argues that the Fed has all the tools necessary to control the money supply and reduce inflation; it lacks only the will to use those tools wisely.

To argue that deficits may not cause inflation is not to say that deficits do not harm the economy. Deficits can be damaging; they do matter. If the Federal Reserve does not buy the government debt or otherwise increase the money supply, the Treasury is forced to finance the debt by entering the private capital markets. The increased demand for funds can lead to higher interest rates and a crowding out of business borrowers, if all other factors are kept constant.

The negative effects of budget deficits is a question of vital importance since the Administration is planning to run sizeable budget deficits over the next years. As Table 2 shows, the U.S. has run large budget deficits in every year since 1970. Those expected under the Reagan Administration are the largest in absolute amounts since World War II. Phillip Cagan, professor of economics at Columbia University and a visiting scholar at the American Enterprise Institute, has suggested that dollar figures are not a proper benchmark for comparison in a growing and especially in an inflationary economy.[14] A commonly used benchmark is to examine the budget deficit as a percentage of GNP. This figure gives an idea of the burden of the government deficit on the total economy. A deficit of $80 billion for 1982 amounts to about 2.5 percent of GNP. While this figure is higher than most years since 1970, the percentage compares favorably with other years of recession like 1975-1976.

Expressing the federal deficit as a percentage of the GNP, however, tells us little about the burden of federal credit demand on private capital markets. A more complete view is to measure all funds raised under federal auspices, including the decicit, as a percentage of private capital markets. Included in the measurement of total funds raised under federal auspices is not just the deficit -- which is only about half of government borrowing -- but guaranteed loans and government-sponsored enterprise borrowing. As Table 3 shows, total federal credit demand has grown dramatically as a percentage of the private capital market in the seventies. The federal presence in capital markets grew from 21 percent to over 36 percent. As recently as 1965-1969,

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[13] Ibid.

[14] Phillip Cagan, "The Real Federal Deficit and Financial Markets," The AEI Economist, November 1981.

Table 2

Measures of the Federal Deficit, 1970-1982
Unified Budget Deficit

Fiscal Year	$ Billions	Percent of GNP
1982 (est.)	80	2.5
1981	57.9	2.0
1980	59.6	2.3
1979	27.7	1.2
1978	48.8	2.3
1977	44.9	2.4
TQ	13.0	3.0
1976	66.4	4.0
1975	45.2	3.0
1974	4.7	0.3
1973	14.8	1.2
1972	23.3	2.1
1971	23.0	2.2
1970	2.8	0.3

NOTE: Fiscal years end June 30 from 1970 to 1976 and September 30 from 1977 to 1982. TQ is the transitional (the third) quarter of 1976. Estimated values for 1982 assume $80 billion deficit, growth in GNP over 1981 of 11 percent, a price increase of 9 percent, average interest cost of 12 percent, and growth in debt of $90-100 billion.

Source: Treasury Department and Board of Governors of the Federal Reserve System in Phillip Cagan, "The Real Federal Deficit and Financial Markets," The AEI Economist, November 1981, p. 2.

the federal share of all public and private borrowing amounted to less than 16 percent.

Any attempt to shrink the federal presence in the capital markets will require a concerted effort to reduce, not only the deficit, but the off-budget borrowing represented by government-sponsored agencies and guaranteed loans. While not even included in the budget, both categories of borrowing crowd out private borrowers as much as does the deficit. In the seventies, the magnitude of government guarantees grew 233 percent. In 1981, the federal government guaranteed the loans of some 150-200 different programs. The best known are the student loan program, Federal Housing Administration, Veterans Administration, and the Small Business Administration.

Government borrowing for sponsored agencies has also grown rapidly during the seventies. In 1981, the federal government raised over $27 billion for sponsored agencies, a staggering increase of over 450 percent since the 1970-1974 period. The

amounts borrowed by these agencies are not shown as a budget item although most were created by the government. The sponsored agencies are now privately owned, but carry on activities sanctioned by government legislation. They are permitted to borrow under the auspices of the U.S. Treasury and, therefore, attain the highest credit rating possible. Within this category is borrowing to benefit farming interests through the Farm Credit Bureau, Federal Land banks, Cooperatives, and many other farming agencies. The Federal Mortgage Association and the Federal Home Loan Bank Board, among many others, are permitted to borrow under federal auspices at risk-free interest rates to support their activities.

Table 3

Federal Share of the Credit Flows*
(fiscal years, in billions of dollars)

	1955-59	1960-64	1965-69	1970-74	1975-79	1980	1981**
Total funds raised	37.1	52.0	80.6	156.9	309.4	344.7	404.0
Total funds raised under federal auspices	7.2	9.6	12.6	32.4	83.7	124.3	146.7
Of which:							
Federal borrowing	2.1	4.5	6.4	13.0	56.0	70.5	71.0
Guaranteed loans	4.7	4.4	5.2	14.4	14.8	32.4	48.0
Government-sponsored enterprise borrowing	0.4	0.7	1.0	5.0	12.9	21.4	27.7
Federal share of all public and private borrowing (in pecent)	19.4	18.0	15.6	21.1	27.0	36.1	36.3

*Includes all credit raised by nonfinancial borrowers, such as corporate and municipal borrowing; farm, business, consumer and mortgage loans, and foreign borrowing. Excludes interbank loans and other credit extended between financial entities.

**estimate.

Source: Department of the Treasury; Federal Reserve Board.

This ravenous federal appetite for credit has become a major impediment to economic growth and prosperity. Undoubtedly, the federal demand for enormous amounts of credit has increasingly driven up interest rates and crowded out business borrowers from the capital markets. This factor appears to be a major cause of the stagnation of the private sector since a shrinking percentage of total capital is available to business and investors.

What does this evidence mean in the debate over accelerating the tax cuts? Some argue that the nation cannot afford to increase the deficit further by cutting taxes. They say that speeding up the tax cut will only lead to more crowding out of the private sector at a time when business needs all the capital it can get. Supply-siders, however, say that tax cuts powerfully stimulate the total funds raised in the capital markets. By increasing the after-tax return to saving, the tax cut is likely to increase accumulated capital more than the federal deficit it causes. The burden of government borrowing as a percentage of the credit market is reduced, leaving a larger pool of capital for the private sector. An acceleration of the tax cut, therefore, should be self-financing, involving no crowding out of the private sector.

This is why supply-siders argue that the effects of deficits on inflation, interest rates, and economic growth depend on how the deficit is incurred. John F. Kennedy contended that there were two kinds of deficits -- both of which produced strikingly different outcomes. The first kind arose from wasteful spending increases; the second kind was caused by tax cuts. The choice is not between budget surplus and deficit, Kennedy concluded, "It is between two kinds of deficits -- a chronic deficit of inertia, as the unwanted result of inadequate revenues and a restricted economy -- or a temporary deficit of transition, resulting from a tax cut designed to boost the economy, increase tax revenue and achieve a budget surplus." Kennedy rejected a budget deficit caused by unnecessary government spending. He accepted, however, a temporary budget deficit resulting from a tax cut because it led to a healthy economy and eventual budget surplus. "The first type of deficit is a sign of waste and weakness," he contended, "the second reflects an investment in the future."[15]

The Undersecretary for Tax Policy at Treasury, Norman Ture, uses similar logic to support tax cuts even when there is a budget deficit. According to Ture, "If the deficit results from tax or spending actions which depress or inadequately stimulate private sector saving, it is indeed likely to be financed by a greater monetary expansion than would otherwise occur, which, in turn, may well result in accentuation of inflationary pressures."

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[15] Representatives Bob Michel, Trent Lott, and Jack Kemp, The Classical Case for Cutting Marginal Income Tax Rates to colleagues in the House of Representatives, February 20, 1981, p. 78.

On the other hand, deficits resulting from a reduction of taxes on work, saving and investment, need not cause higher interest rates or inflation. According to Ture, "Supply-side tax reductions of the sort recently enacted, which reduce the relative cost of saving, are likely to generate a sufficient increase in private sector saving to eliminate the need for any monetary expansion to finance the deficit such tax cuts produce."[16]

There are early, though not yet conclusive indications that the recent first stage of the tax cut, small though it is, may eventually pay for itself in increased saving. In the first two months of the 5 percent tax cut, saving increased almost $18 billion. The savings rate increased from 4.6 percent in February 1981 to 5.1 percent in August to 5.4 percent in September and to 5.9 percent in October, the latest figures available.

Table 4

1981	Percentage of Personal Income Devoted to Saving	Total Amount Saved by Individuals (billions)
Jan.	5.0	$ 83.6
Feb.	4.6	91.0
March	4.9	92.2
April	5.2	106.0
May	5.4	109.4
June	5.4	104.4
July	5.1	108.2
Aug.	5.1	94.9
Sept.	5.4	106.6
Oct.	5.9	135.1
Nov.	*	124.0

*Not available

Source: Bureau of Economic Statistics

Even relatively small changes in the percentage of income devoted to saving can, in the aggregate, mean enormous increases in saving and investment. While a portion of this increase can be attributed to the all-savers certificates, the fact is that in the two months following the initial 5 percent tax cut, the pool of saving available to investors and business entrepreneurs has increased impressively. This step-up in saving has occurred even though the major incentives to savers -- IRA and Keogh Retirement

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16 Norman Ture, "New Directions in Economic Policy," Tax Review, Vol. XLII, No. 9 (October 1981).

plans, and the reduction in the top tax rates on interest income from 70 percent to 50 percent -- began only on January 1. The increased capital formation will eventually translate into higher economic growth and more employment.

Accelerating the tax cut will also provide incentives for the growing number of unemployed to give up government aid and seek employment in the private sector. The reason: tax cuts lure people back into the labor force by providing them a greater reward for the their work effort. Without these incentives, many find unemployment compensation or welfare more attractive than working -- and in many instances it is. The combination of rising taxes on wage rates and the availability of substantial welfare benefits can make unemployment more attractive than working.

The General Accounting Office in 1979 found that for one-quarter of the unemployed, welfare benefits replaced more than 75 percent of their paychecks; for 7 percent, such benefits exceeded take-home pay. The Wall Street Journal reported that "On average unemployment benefits replace 64 percent of take-home pay, and if work-related expenses such as transportation and child care are deducted, returning to work means giving up one's leisure for very little."[17] This problem becomes especially severe in a recession when job opportunities may decline, take-home pay is reduced, and factories shut down. In such circumstances, the differential between unemployment insurance and take-home pay narrows yet further. Harvard Economist Martin Feldstein found that a marginal tax rate of 30 percent creates a disincentive to working that raises unemployment by 1.25 percent and shrinks GNP and the tax base by the lost production of one million workers.[18] In a recession, the number of unemployed is certainly swelled by disincentives created by high taxes.

CONCLUSION

Many economists, even some supply-siders, mistakenly thought during last summer's tax debate that positive economic growth could be stimulated quickly by the watered-down tax cut bill. Americans will not increase investing, saving, and working, however, until their tax rates actually fall. At the time the tax cut cleared Congress, the press reported the measure as "bold and radical," calling it the most massive cut in history. During the first two years of the Reagan program, however, the effect of the tax cut on net wealth of taxpayers is trivial after counting taxes which rise automatically. Although the business tax cuts took effect retroactively and the top personal income bracket came down from 70 percent to 50 percent January 1, positive

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17 Michel, Lott, Kemp, op. cit., p. 23.
18 Ibid., p. 24.

supply-side effects probably cannot be expected until the total tax burden on capital and labor is brought down significantly. The result is that relatively few gains from the tax cut plan will be evident by November. The chief danger is that supply-side economics might be judged a failure even before the strategy has been tried. As for the recession, its severity probably has been exacerbated by those who diluted the original Reagan tax cut and delayed its effects. Accelerating the personal tax cuts will remedy that mistake and give the private sector a breather from further tax hikes.

Thomas M. Humbert
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APPENDIX 1

Table 1
Combined Effects on Individual Tax Payments of Personal Tax Cuts and Social Security Increases and Bracket Creep
(in billions)

Calendar Year	Increase: Social Security*	Increase: Bracket Creep	Increase: Total	Personal Tax Cuts**	Net Change
1981	6	13	19	-4	15
1982	13	28	41	-41	0
1983	19	53	72	-84	-12
1984	26	77	103	-116	-13

*Increase in tax rates plus increase in base above that consisted with growth of incomes.

**Rate reductions, indexing, and reduction of marriage penalty.

Source: Office of Tax Analysis